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C O N F I D E N T I A L SECTION 01 OF 03 BUDAPEST 000078

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STATE FOR S/CEE FOR AMB MORNINGSTAR AND REBECCA NEFF, EEB/ESC FOR DOUG HENGEL AND ALEX GREENSTEIN, EUR/CE FOR JMOORE, EUR/ERA FOR SJOHNSON, AND EUR/RUS. COMMERCE FOR HILLEARY SMITH. ENERGY FOR MAPICELLI AND MCOHEN. PLEASE PASS TO NSC JHOVENIER.

E.O. 12958: DECL: 02/05/2020
TAGS: ENRG ECON EPET PGOV HU
SUBJECT: ALLEGATIONS OF POLITICAL CORRUPTION SURROUND ENERGY UNBUNDLING LAW

Classified By: Economic Officer, Jeffrey M. Jordan for reasons 1.4 (b), (d)

¶1. (SBU) Summary: The Hungarian Parliament recently passed legislation to incorporate the EU's energy unbundling directives. However, the legislation has been widely criticized because of the influence of energy conglomerates MVM and MOL on the bill, for the lack of input from government or industry experts, and for extending a system of controversial energy subsidies to gas-fired power plants. Critics generally believe campaign financing, rather than improved energy market competition, to be at the heart of this legislation. End summary.

PARLIAMENT OUTSOURCES ENERGY UNBUNDLING LEGISLATION...

¶2. (SBU) On December 14, just before breaking for its winter recess, the Hungarian Parliament passed a complex modification of Hungary's basic electricity and gas legislation to implement the energy unbundling provisions of the EU's "Third Energy Package." The measure passed with an overwhelming 329-17 majority that included the rare unanimous support of the ruling Socialist and the opposition Fidesz parties, two of whose members had submitted the legislation. The move has come under intense criticism from energy experts who accuse the Parliament of failing to consult with, or even inform, relevant public administration organs such as the Hungarian Energy Office, instead outsourcing the drafting of the law to state-owned electricity company MVM and publicly-traded oil and gas giant MOL, the two companies most likely to benefit from the legislation.

¶3. (SBU) The Third Energy Package allows member states until 2011 to choose, on the basis of extensive expert studies and consultation with stakeholders, from among three options to separate energy supply and production activities from energy transmission networks - i.e., gas pipelines and the electrical grid. Under "full ownership unbundling," integrated energy companies would be forced to sell off their gas and electricity grids. The "independent system operator" (ISO) model would allow companies to retain ownership of the network, but would require them to hand over management control to an independent company, which would make commercial and investment decisions. The "independent transmission operator" (ITO) model, the lowest threshold for unbundling allowed by the EU, allows energy suppliers to retain ownership of their transmission system operators

(TSOs), provided that strict rules are in place to ensure that the TSOs operate independently. The Hungarian Parliament's selection of the third method, the ITO model, essentially codifies the status quo, enabling MVM and MOL to remain the dominant, vertically-integrated players in the Hungarian electricity and gas markets.

¶4. (SBU) Parliament also extended by five years, until 2015, certain energy producers' eligibility for Hungary's "mandatory offtake" system whereby qualifying electricity generators are able to sell power into the grid at a price well above market rates (the so-called "feed-in tariff"). Originally conceived as a means to promote electricity generation based on renewable energy sources, over time, and due to effective lobbying, the system grew to include small and medium-sized gas-fired co-generation plants, which produce electricity as well as heat for district heating stations. The system also includes Hungary's two large coal-fired plants, Matra and Vertes, which qualified by incorporating some biomass into their production process. Currently, about 75 percent of the 80 billion forint (roughly $413 million) annual subsidy goes to gas-fired co-gen plants.

¶5. (SBU) The legislation also incorporates the EU's so-called "Gazprom clause," which mandates reciprocal market access for non-EU countries with companies wishing to purchase stakes in EU TSOs. In what appears to be an effort to further protect MOL from Russian takeover, the Hungarian legislation applies the Gazprom clause not only to TSOs, but also to energy holding companies.

... BUT LEAVES ENERGY REGULATOR OUT OF THE LOOP

¶6. (C) Gabor Szorenyi, Director of Electricity, Gas, and District Heating Licensing, Monitoring and Consumer Protection at the Hungarian Energy Office (HEO), confirmed to Econoff that the HEO had been blindsided by the ITO law. Szorenyi said that, based on the EU directive, the HEO had been conducting "deep analysis" for six months to recommend the most appropriate course for Hungary, but that Parliament had approved the MVM/MOL-prepared text in a matter of weeks without consulting the industry, the government, or the regulators. According to Szorenyi, Parliament "totally neglected the idea that unbundling is supposed to promote competition." The legislation, he says, contains inadequate provisions to ensure the independent operation of the TSOs. The HEO plans to complete its study and present it to the Hungarian Government, but Szorenyi is not optimistic that it will have an impact. Szorenyi expressed his view that the HEO is "alone in the fight" against this legislation, but added that the EU has already registered its concerns as well.

INDUSTRY PLAYERS: LAW BENEFICIAL FOR ENERGY SECURITY, BUT DAMAGING TO COMPETITION

¶7. (C) Laszlo Varro, Chief of Strategy for MOL, told Econoff that the commentary in the press, and specifically the complaints raised by the HEO, have mischaracterized the issue. Varro said the ITO model is the only sensible course for MOL because the risk is too great that the Russians, who have already demonstrated their willingness to pay a huge premium for Hungarian energy assets in their acquisition of a 21 percent stake in MOL, would end up owning the gas pipelines. He noted that the ISO model had already been tried at MVM when, during the previous Fidesz government, grid operator MAVIR was run independently but subsequently "re-bundled." According to Varro, a shortcoming of the ISO model is that the TSO infrastructure often lacks needed investment since two separate companies own and manage the assets. Moreover, Varro says that MOL's TSO already operates relatively independently and that it does not abuse its position.

¶8. (C) MOL's competitors in the gas business, however, do not share this benign view. Istvan Kutas, PR director for E.On Hungaria, Hungary's primary importer of Russian gas and dominant gas wholesaler, told Econoff that the ITO law would strengthen Hungary's national champions, MVM and MOL, at the expense of market competition. According to Kutas, the two companies' trading arms are able to take unfair advantage of grid information not available to other competitors and suggested that they may also receive discounted access to the grids due to their common ownership. HEO Director Szorenyi agreed and added that the HEO currently lacks the capacity to provide adequate oversight to ensure a level playing field. "We haven't yet discovered all their tricks," he said.

¶9. (C) Kutas and Szorenyi separately noted that MVM and MOL both appear to be actively growing their energy supply and trading operations. MVM, already dominant in the electricity market, recently applied for a gas-trading license and is actively purchasing stakes in power plants, wind power projects, and electricity distributors around Hungary. MOL's trading division, MOL Energy Trade (MET), according to Varro, primarily exists to manage oil, gas, and electricity supplies for MOL's own operations (refineries, etc.), although Varro admits that MET engages in some energy trading for purposes of "portfolio management." Most contacts, however, view the recent sale of a 50 percent stake in MET to Normeston Trading, a Belize-registered offshore entity rumored to be owned by "Russian individuals," as an effort to gain its own access to Russian gas. Moreover, Kutas informed us that MOL, together with Gazprom trading arm Centrex, has recently cherry-picked some large customers from E.On and that MOL has now replaced E.On as the sole supplier to troubled gas trader/retailer Emfesz. (Note: MOL and MVM are both widely considered to be possibe acquirers of nearly-bankrupt Emfesz. End note.) In light of such developments, Szorenyi

considers the ITO law a big step backward: "When MOL sold its gas trading activities to E.On in 2004, that was real unbundling, but now it is stepping back."

FIDESZ POLITICIANS: 1, FIDESZ EXPERTS: 0

¶10. (C) The legislation has brought to light some internal divisions between the young experts and the old guard within Fidesz, Hungary's main opposition party and probable winner of upcoming general elections in April. Fidesz energy expert Gellert Horvath told Econoff that Janos Fonagy, the Fidesz MP who sponsored the legislation, managed to stifle internal debate over the measures and obtain support for a party-line vote, effectively sidelining a committee of experts the party recently established to formulate its energy policy. As a result, the committee suspended its operation in protest.

IT ALL BOILS DOWN TO PARTY FINANCING

¶11. (C) The energy law modifications featured prominently at a recent conference the Hungarian energy NGO Energia Klub sponsored to mark the release of its extensive study on corruption in the energy sector. In her remarks to the conference, Marty Nagy, former Vice President of the Hungarian Competition Authority, called the law "the apex of corruption," saying that Parliament had abdicated its duty to the public in outsourcing the legal drafting to the vested interests, probably in exchange for political party financing. After the conference, Energia Klub Director Ada Amon admitted to Econoff that it is difficult to find hard evidence of corrupt transactions, but emphasized that in such a case where vested interests are so clearly served and public interests ignored, despite the protests of a wide range of experts, corruption can be the only plausible explanation. HEO Director Szorenyi also believes the parties' quest for campaign financing, ahead of elections in April, was a key motivation behind the legislation.

¶12. (C) Amon, Szorenyi, and Varro separately expressed

serious concern about the extension of the mandatory offtake regime through 2015. Each interlocutor described the system as inherently corrupt and driven by a powerful lobby, with deep connections to the Socialists and Fidesz, that has steered the subsidies away from the originally intended recipients, renewable energy producers, and toward gas-fired co-gen plants. The parties have repeatedly blocked efforts by the HEO to reform this system. When the recent measures were passed, the HEO was in the process of issuing statements informing certain producers that, based on its calculations, they were no longer eligible for the subsidy because they had already recaptured their capital investment. According to the new rules, such plants will be eligible for the subsidy for 7.5 years, even if they're already earning a return on investment.

¶13. (C) Comment: Parliament's passage of the ITO law highlights the very real trade-offs Hungarian leaders must make as they seek to ensure Hungary's energy security while complying with EU competition directives. From this standpoint, Parliament's attempt to prevent a Russian takeover of the MOL gas grid is completely understandable. However, the non-transparent manner in which the legislation was passed suggests a possible modus vivendi between the Socialists and Fidesz when it comes to illicit campaign fundraising. It is an open secret in Hungary that MVM and MOL provide significant funding to the two main political parties, with MVM rumored to favor the Socialists and MOL favoring Fidesz. MVM also provides substantial direct financing for the Hungarian state in the form of annual dividends: on December 23, the company announced a 20 billion forint ($104 million) "advance dividend" on its 2009 profits. End comment.

KOUNALAKIS